



# The Common Good: What Pennsylvania's Budget and Tax Policies Mean to You

A Tax Primer from the Pennsylvania Budget and Policy Center





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Founded in 2005, The Pennsylvania Budget and Policy Center (PBPC) is a nonpartisan, statewide policy research project that provides independent, credible analysis on state tax, budget, and related policy matters, with attention to the impact of current or proposed policies on working families.

The Budget and Policy Center analyzes and disseminates information on short-term budget, policy and revenue proposals as well as long-term trends and challenges.

The Pennsylvania Budget and Policy Center participates in a national network of similar organizations that exist in over half the states as part of the State Fiscal Analysis Initiative coordinated by the Washington, DC-based Center on Budget and Policy Priorities. The Pennsylvania Budget and Policy Center is a project of the Keystone Research Center.

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# Executive Summary: The Common Good

Public investments make a difference. Your tax dollars combine with everyone else's to educate our children, keep our communities safe, move people to work over roads and transit systems, and care for the disabled and poor.

Can't picture it? Try this. Imagine you're in a car, traveling a Pennsylvania highway. That road is paid for and maintained with gas taxes and car registration fees. You pass a transit van for senior citizens, supported by state lottery funds and sales taxes. You stop at a diner for a meal that's safe to eat, because your tax dollars make sure the restaurant is inspected and the water is purified and tested. You drive by an elementary school and a community college, paid for with state and local taxes. At a senior center, elderly Pennsylvanians are getting help with their prescription assistance forms. Two men fly fish in a stream that is stocked using public funding. State Police officers are responding to an accident. Men and women are going to publicly financed

jobs that serve the common good — at the prison, the local hospital, the university, the water treatment plant, the library.

Your community benefits. So does your family. No one likes to pay taxes, but in the end, they build the foundation for a society where families and businesses can thrive.

Some people think taxes should be lower. Others think they could be higher. How do we know which is right? One way is to ask the questions that this primer investigates:

- How is government spending beneficial?
- What's in the state budget?

Your community benefits.  
So does your family.





- What are the state's major taxes and who pays them?
- What do local governments do and how are they funded?
- How do Pennsylvania's spending and taxes compare to other states? How have spending and taxes changed over time?
- How do we fund education, our largest state and local expenditure?
- Is our tax system fair? Does it raise enough to keep up with our needs?

With this information, we can have an informed discussion about the bigger question—are our taxes and spending fair and appropriate to our needs, as individuals and as a community? Answers aren't always easy, but this report draws these conclusions:

- Pennsylvanians pay taxes that allow state government to provide services that improve our quality of life, protect the vulnerable, and support economic development and growth.



- Most state spending is in three critical areas: education, health care, and public safety. The Commonwealth also invests heavily in transportation and services to seniors.

- Pennsylvania is not a high spending or high tax state. When measured against other states, the Commonwealth ranks 32<sup>nd</sup> in state taxes and 30<sup>th</sup> in state spending as a share of state personal income.
  - State spending and taxes as a share of income remained stable, without increases, over the last 20 years.
  - Pennsylvania state taxes are relatively low. The personal income tax rate is the second lowest top rate in the country, and the state's sales tax at 6% is in the middle of all states.
  - The state corporate income tax rate is relatively high, 9.99%, but few companies pay the tax due to the narrow tax base.
- Pennsylvania relies heavily on local taxes and spending. Local taxes represent 4.3% of state personal income, ranking 18<sup>th</sup> in the nation.
- Pennsylvania's living standards, measured in personal income per person, have risen steadily and at the same pace as the nation over the past 20 years. But since 2000, income growth has been concentrated at the top, with low- and middle-income families falling behind.
- Pennsylvanians have made schools a priority. Over time, student performance has improved, but funding levels are too low to ensure every child can meet strict performance targets.
  - Pennsylvania relies more on local property taxes to fund schools than most other states. Pennsylvania ranks 4<sup>th</sup> highest in its percentage of school funding provided by local governments. As a result, there are wide disparities in local funding and high taxes in some areas.

- Pennsylvania has one of the most regressive state and local tax systems in the country. Low-income families in Pennsylvania pay more than 12% of their income in sales, property, and income taxes while the wealthiest families pay only 4% of their income in taxes.
- Pennsylvania's state tax system is generally stable because it relies on a blend of income and sales, and individual and corporate taxes. However, the tax system's future ability to raise sufficient funds is threatened by declining corporate tax revenue, and a tax system that has not been comprehensively updated and reformed in generations.

With a common understanding of state spending and taxation plus a shared vocabulary and background, citizens and policymakers can make good decisions on taxing appropriately and investing our dollars well.

## State Spending Reflects Pennsylvania's Unique People and Economy

The state's people and its economy shape how we are taxed and the services we need. With more than 12.4 million residents, Pennsylvania has the nation's sixth-highest population. That's why Pennsylvania has a relatively large General Fund of \$27.2 billion in state funds in 2007-08. Our large and diverse population creates great demands for services and investments that protect our quality of life and support economic

development and growth. These factors affect how much is collected in taxes and how much is spent on services:

**Transportation:** Pennsylvania is a manufacturing center and sits at the crossroads of the Northeast, Midwest, and South, so a well-developed transportation system is necessary to move goods produced here to market. While we are not a large state geographically, we rank ninth in the U.S. in number of bridges (22,176) and 10<sup>th</sup> in highway lane-miles (252,739).

**The elderly:** Pennsylvania has the third-highest proportion of residents over 65 — more than 15% compared to 12% nationally. In general, the elderly pay less in taxes because Pennsylvania chooses not to tax Social Security and retirement income. As Pennsylvanians age, they need more help to live healthy, independent lives, and they rely on state-funded health care, transportation, and prescription drug subsidies.

**Population changes:** Pennsylvania's population has grown more slowly than most states, averaging .3% a year since the 1970s. But growth isn't evenly distributed. While 46 counties have gained population since 1970, the other 21 have lost population. The fastest-growing counties are gaining residents from New York, New Jersey and Maryland.

Growing counties need more services, such as schools, sewer systems, roads, recreation facilities, and law enforcement. Shrinking counties have problems of their own, because the cost of many services remains fixed, even when the population falls and tax bases decline.

With more than 12.4 million residents, Pennsylvania has the nation's sixth-highest population.



# Section I:

## The State Budget

The state budget defines how tax dollars will be used to support economic growth and provide services to citizens. Most services and programs are funded with a combination of state, federal, and local revenue.



### How the Budget Happens

Lawmakers must adopt a balanced budget, meaning that money going out can't exceed money expected to come in. The need for services and investments is generally much greater than the funds available each year, and to reach a balanced budget, the governor and legislature must set priorities.

Every February, in the state capital of Harrisburg, the governor unveils a spending plan for the fiscal year that begins July 1.

Appropriations Committees in the state House of Representatives and the Senate review the proposed budget and invite the heads of every state agency to appear at hearings to answer questions. Pennsylvania does not have public budget hearings that would allow citizens to comment or ask questions.

When the legislative hearings are concluded, each chamber introduces an appropriations bill that details spending. The bills ordinarily reflect the governor's original proposal but might include additions that reflect the priorities of that particular chamber, or cuts that signal lack of support for some programs. Separate code bills are introduced to put into law any changes that are required to implement the budget plan.

Throughout the year, lawmakers closely watch state revenue numbers, which figure heavily in the final budget plan. If tax revenue is greater than predicted, the state has a budget surplus. In this case, the legislature must put 25% in an emergency savings account called the Rainy Day Fund and can spend the rest. If there's a deficit — as in, less money coming in than expected — the legislature must cut spending, increase revenues, or withdraw money from the Rainy Day Fund.



The Constitution requires that a budget be in place by the beginning of the state fiscal year on July 1. As the deadline approaches, legislative leaders and the governor negotiate a budget that will secure enough votes to pass both chambers. In recent years, that has proven difficult, and lawmakers have often missed the deadline by several days, and once by several months.

## Pennsylvania's General Fund: The Sum of Many Parts

The 2007-08 state budget included more than \$59 billion in state and federal funds. Pennsylvania individuals and businesses paid for much of it through taxes and fees, collected into four types of funds: the General Fund, federal funds, special funds, and minor funds.

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### THE GENERAL FUND: \$27.2 billion, 46%

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**Pennsylvania raises the money that goes into the General Fund.** When the governor and legislature debate a state spending plan every year, they are usually referring to the General Fund. Revenues in this fund are not restricted — or “earmarked” — and can be allocated to any of the state’s priorities, from education to health care to the environment.

Personal income and sales taxes account for more than two-thirds of all General Fund tax revenue, while corporate taxes contribute another 20%. Other taxes add 9% to the fund. Non-tax revenue, fees and other income represent almost 2% of state General

Fund revenues. These can include things like state liquor store profits, interest on investments, teacher certification fees, and rental fees for state park campgrounds.

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### FEDERAL FUNDS: \$18.2 billion, 31%

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**Roughly one-third of the state budget comes from the federal government.** The federal government decides how most of it will be spent. How much Pennsylvania receives for some specific programs, such as food stamps, is based on need. In other cases, if we’re willing to spend more of our own money, we can also receive additional matching funds. For example, if Pennsylvania helps families, the elderly and disabled pay for health care through the Medicaid program, it can draw down additional federal money to serve even more people.

**Federal block grant funding has been declining.** Since the mid-1990s, the value of many federal block grant programs has declined, requiring additional state funds just to keep pace.

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### SPECIAL FUNDS: \$5.1 billion, 9%

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**Revenue in the special or dedicated funds, including the Lottery Fund, Motor License Fund, and Tobacco Settlement Fund, comes from specific sources and is spent on particular programs.** Think of these funds as restricted bank accounts that can only be spent for specific purposes. The Lottery Fund helps seniors pay for prescription drugs and get rides to the doctor, while the Motor License Fund pays for repairs to state and local roads.

The need for services and investments is generally much greater than the funds available each year.



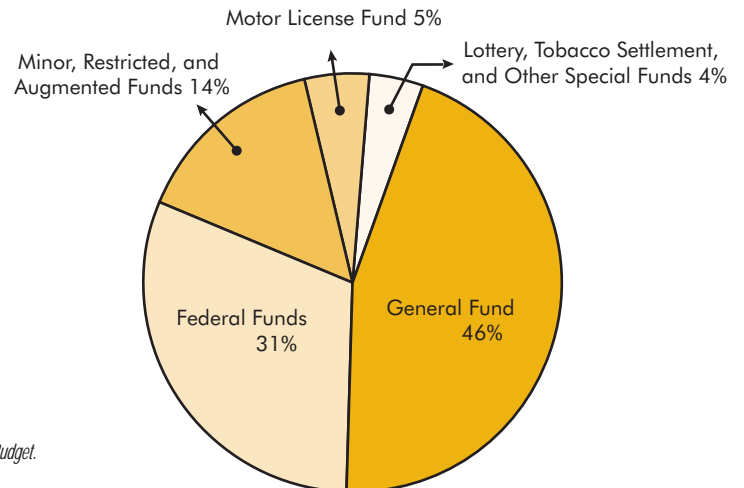
## MINOR AND RESTRICTED FUNDS: \$8.6 billion, 14%

**More than 100 “minor and restricted funds” range widely in size and scope.** Casino revenues go into the Property Tax Relief Fund for local property tax reductions, and proceeds from the sale of fishing licenses go into the Fish Fund and are used to stock trout streams.

**JARGON ALERT:** Dedicating, or “earmarking,” funds for specific purposes can be good and bad. It can ensure that certain revenue supports specific priorities, such as employee pensions or stocking lakes and creeks with fish. But it can be a bad thing, taking away lawmakers’ ability to shift spending as priorities change.



## Pennsylvania Revenue Sources by Fund, 2007-08 Total Funding: \$59.1 Billion



Source: Commonwealth of Pennsylvania, 2008-09 Governor's Executive Budget.

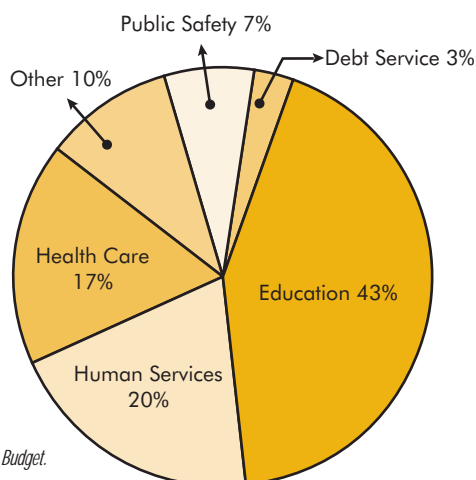


## General Fund Spending

The General Fund supports most state government operations, pays the debt service on state borrowing, and funds services delivered by hundreds of school districts, counties, hospitals, and colleges. Two-thirds of General Fund spending goes to three things: education, health care and public safety. Another 20% supports human services, including child protection, adoption programs, mental health services, and programs for the developmentally disabled.

## General Fund Spending, by Function, 2007-08

Total General Fund Spending: \$27.2 Billion



Source: Commonwealth of Pennsylvania, 2008-09 Governor's Executive Budget.

### EDUCATION: \$11.5 billion, 43%

**The biggest General Fund expense is education.** The education budget includes \$9.3 billion for prekindergarten through 12<sup>th</sup> grade students, including \$5 billion in Basic Education payments to Pennsylvania's 501 school districts and another \$1 billion to educate children with special needs. Higher education, including community colleges and state universities, accounts for another \$1.6 billion, or 6% of total General Fund spending.

### HUMAN SERVICES: \$5.5 billion, 20%

**Human services support vulnerable citizens, delivered through the state Department of Public Welfare (DPW).** The department name is somewhat misleading, because only 3% of DPW's funding supports what is known as welfare, or cash grants to dependent mothers and children. The department manages five major functions: health care, human

services, mental retardation, mental health, and income maintenance. In many other states, separate departments provide these functions.

### HEALTH CARE: \$4.6 billion, 17%

**Most of the state's health care spending is for the Medicaid program, which is jointly funded by the state and federal government. Medicaid provides access to health care services to 1.8 million children, pregnant women, elderly and disabled citizens.** Although children and families make up 60% of Medicaid enrollment in Pennsylvania, almost two-thirds of Medicaid spending goes to care for the elderly and disabled. Much of the state's Medicaid spending reimburses doctors, hospitals, and nursing homes for care of the elderly and infirm.

The General Fund supports most state government operations, pays the debt service on state borrowing, and funds services delivered by hundreds of school districts, counties, hospitals, and colleges.



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#### PUBLIC SAFETY: \$1.9 billion, 7%

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**Most of the state's public safety funds — \$1.6 billion — go to the Department of Corrections to house more than 44,000 inmates in 26 correctional institutions.** The rest supports the Pennsylvania State Police and probation and parole services.

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#### DEBT SERVICE: \$0.9 billion, 3%

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**The Commonwealth pays for capital improvements and long-term expenditures by borrowing funds and paying debt service.** The way the state borrows and then pays for capital improvements through debt service is similar to the way a family borrows and then pays off a home mortgage over time.

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#### ALL OTHER: \$2.8 billion, 10%

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**The Commonwealth's other programs and services, delivered by 30 state agencies, account for 10% of the state's General Fund.** The Department of Community and Economic Development gets the biggest share of the remainder — \$640 million for local economic development programs and workforce investments — plus local initiatives favored by legislators known informally as Walking Around Money, or WAMS. The Civil Service Commission gets the smallest agency allocation — \$1,000 each year.

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#### PUBLIC TRANSPORTATION TRUST FUND: \$790 million

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The state's 42 regional mass transit agencies receive funding from the Public Transportation Trust Fund, created in 2007 and funded with a share of the state sales tax.

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#### LOTTERY FUND: \$1.6 billion

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Most states have lotteries to raise funds for specific purposes, such as public or higher education. **Pennsylvania's lottery dollars provide services for seniors**, including prescription drug subsidies, shared rides and free transportation, and long-term care. About \$300 million subsidizes property taxes paid by low-income senior citizens.

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#### TOBACCO SETTLEMENT FUND: \$430 million

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In the 1990s, **Pennsylvania received \$11 billion over 20 years from a settlement of a multi-state suit against big tobacco companies**, and as compensation for some of the costs of treating smoking-related illnesses. The state uses its tobacco settlement funds for health insurance, smoking prevention and cessation, and payments to hospitals to care for the uninsured.

## Spending From Special or Earmarked Funds

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#### MOTOR LICENSE FUND: \$2.7 billion

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Although transportation is a key responsibility of state government, **virtually all transportation programs rely on dedicated funding sources.** Under the state Constitution, gasoline tax money must be spent on highways, so most of the Motor License Fund supports road and bridge construction, with some funds for Pennsylvania State Police and other uses.





## WELFARE SPENDING IN PENNSYLVANIA

The Pennsylvania Department of Public Welfare has the second largest budget of the state's 28 agencies, \$9.7 billion in 2007-08. Some people believe that Pennsylvania spends too much on welfare, but DPW's biggest responsibility — 45% of its budget — is the state's Medicaid, or Medical Assistance, program. Medicaid provides comprehensive health care to more than 1.8 million low-income children and families, seniors, and citizens with disabilities.

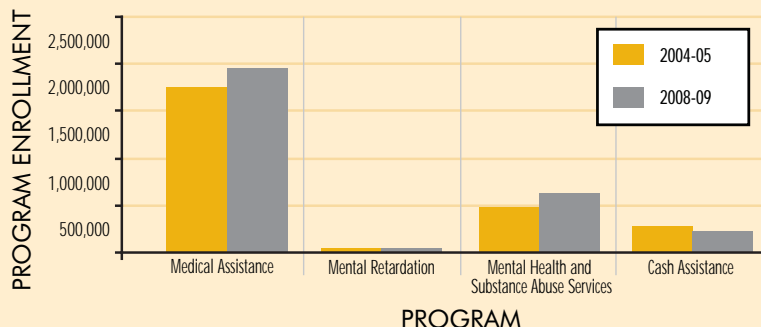
### Medical Assistance Makes Up Almost Half of the DPW General Fund Budget, 2007-08 Total DPW Spending: \$9.7 Billion

Source: Commonwealth of Pennsylvania, 2008-09 Governor's Executive Budget

Only 3% of the DPW budget, \$273 million, goes for the cash grants traditionally called welfare. In June 2008, about 200,000 Pennsylvanians, 70% of them children, received cash assistance — a 60% drop since passage of welfare reform in 1996. The Commonwealth has been aggressive in helping families with child care, employment training, and work supports to move them off welfare. It has also been aggressive — too aggressive, some say — in discouraging people from applying for temporary assistance.

Enrollment data from 2004-05 to 2008-09 shows that demand for other DPW programs is growing. In contrast to the declining welfare rolls, demand for other DPW services — Medical Assistance, mental health and substance abuse, and mental retardation programs — is on the rise.

### Medical Assistance, Mental Health and Mental Retardation Service Enrollments Climb as the Number of Cash Assistance Recipients Fall, 2004-05 to 2008-09



Source: Commonwealth of Pennsylvania, 2008-09 Governor's Executive Budget and 2006-07 Governor's Report on State Performance.

State government isn't the only provider of public services. Local governments provide many of the public goods that we use every day.

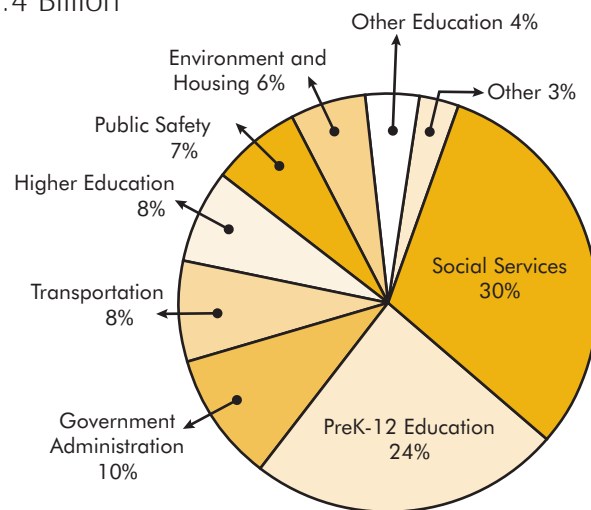


## Local Governments Also Provide Services We Use Daily

State government isn't the only provider of public services. Local governments — counties, cities, boroughs, townships, and school districts — provide many of the public goods that we use every day.

Pennsylvania's 67 counties provide the foundation for our legal system through their sheriffs, courts, and jails. They also operate local 9-1-1 systems, and provide needed aging and mental retardation services. The 56 cities, 960 boroughs, and 1,547 townships provide police and fire protection for our communities, help us plan for the future with zoning boards, and pave, clean, and remove snow from local streets. Statewide, 501 Pennsylvania school districts educate children, from prekindergarten through high school.

**Pennsylvania State and Local Government Spending by Function, 2005-06**  
Total Spending: \$89.4 Billion



Source: U.S. Census (Direct general expenditures)



## Section II: Who Benefits?

### Tax Dollars Support Our Quality of Life

Pennsylvanians have much to be proud of and thankful for. We have a long history of good-paying jobs, safe communities, good public schools for our children, and a well-developed system of public colleges. We have abundant natural resources and are centrally located between important economic regions.

We also have challenges. Our population is not growing as quickly as some states. Our economy has lost many of its well-paying jobs — manufacturing jobs to overseas factories, and coal and steel jobs to declining use and foreign competition. We have aging rural communities and poverty-stricken central cities.

Government has a hand in supporting our successes and addressing our challenges. Smart investments in public goods, such as education, workforce development, and higher education, are needed to help our economic transformation to a knowledge-based economy.

In many ways, Pennsylvania outperforms the nation in basic quality of life, but more needs to be done.

### Pennsylvanians Are Less Likely to Live in Poverty Than Most Americans

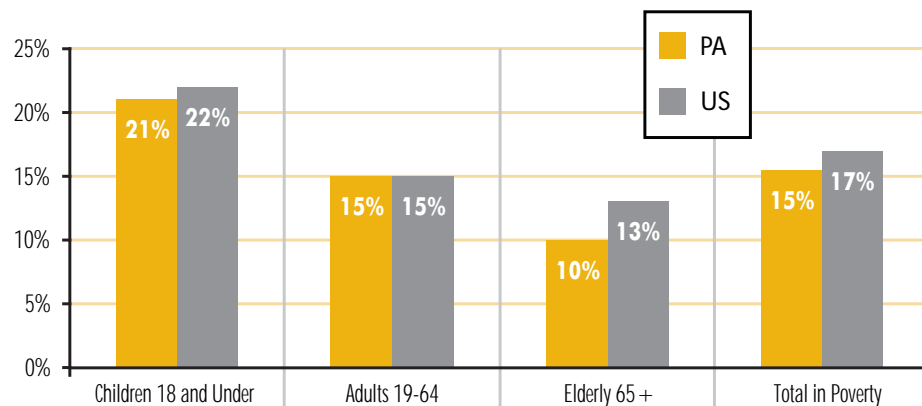
Almost 2 million Pennsylvanians — 15%, compared to 17% nationally — live in poverty, which is roughly \$21,000 for a family of four. Among Pennsylvania's seniors, 10% are poor, below the national average of 13%. Pennsylvania children are slightly less likely to be poor

Almost 2 million Pennsylvanians live in poverty, which is roughly \$21,000 for a family of four.



than children across the nation, but still, they make up one-third of all poor people in Pennsylvania. Pennsylvania helps to reduce poverty through state workforce programs that build job skills, state financial assistance for child care, and programs like heating assistance and food stamps that supplement family incomes.

### Fewer Pennsylvania Elderly and Children are in Poverty than the U.S. Average



Source: U.S. Census data compiled by the Kaiser Family Foundation, StateHealthFacts.org. Pennsylvania data is the average of 2005 and 2006, while the U.S. data is from 2006.

### A Bigger Share of Pennsylvanians Than Americans Have Health Insurance

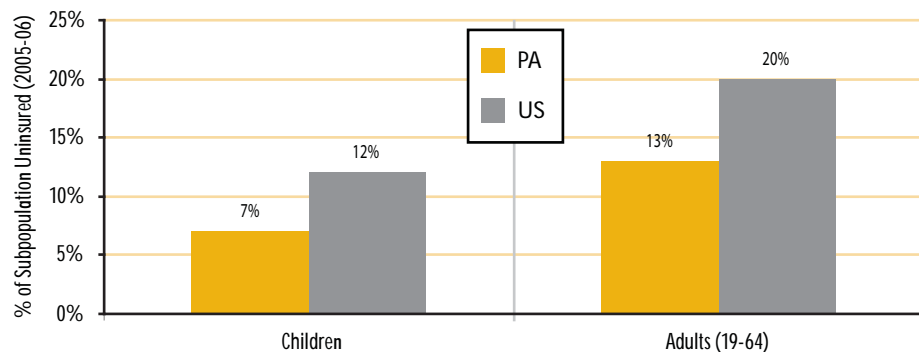
More than 70% of Pennsylvania adults and 63% of children get health insurance through an employer — well above the national average. That's due to a proud tradition of employment-based coverage in large companies, plus strong public programs for seniors, adults, and kids.

The choices we have made, through our policymakers, have made a meaningful difference in the lives of our old and our young. Congress created Social Security, Medicaid, and Medicare so that our grandparents wouldn't be poor and could afford health care to prolong their lives.

Pennsylvania has made similar choices. We devote our state lottery funds and other resources to help seniors afford prescription drugs. We have chosen to provide health insurance coverage to every child through Cover All Kids, and to some lower-income working adults with Tobacco Settlement Funds. Medical Assistance is open to poor seniors and adults with incomes slightly higher than the federal minimum. The Commonwealth is a national leader in services to help children and adults with autism. These choices have meaningfully improved the lives of our neighbors and family members.



## Children and Working-Age Adults Are Less Likely to be Uninsured in PA than in the U.S.



Source: U.S. Census data compiled by the Kaiser Family Foundation, StateHealthFacts.org. Pennsylvania data is the average of 2005 and 2006, while the U.S. data is from 2006.

## Pennsylvania Students Perform Well and Are Getting Better

Public education in Pennsylvania is a joint responsibility of state government and local school boards. Citizens have made a big commitment to their schools, using state funds and local property taxes. We get good results for our money. Pennsylvania students outperform much of the nation, and student performance is improving over time:

- Fourth- and eighth-grade students score higher than average on national writing tests, and more students perform at an advanced level than the national average. On many measures of student performance, Pennsylvania scored in the top 10 of all states.

- Since 2002, Pennsylvania students have shown improvement on standardized reading and math tests in fifth, eighth, and 11<sup>th</sup> grades, and the share of students scoring in the highest groups is growing faster than in most states.

## Public Investments Strengthen the Pennsylvania Economy

State investments make the state's private sector more productive. Surveys show that businesses look for a skilled workforce, a good quality of life for their employees, and access to markets, including a good transportation system, when deciding whether to relocate or expand. State investments in these services make the Commonwealth more attractive to employers.

When the economy stumbles, states often find themselves in financial trouble as tax collections fall.



Government spending is also an important part of our overall economy. Governments pay salaries and build demand for goods and services which create additional jobs in communities across Pennsylvania. Almost 80% of all state funds goes back to our communities and is spent by local governments, school districts, hospitals, non-profits, and businesses. The rest of the state funds are spent directly, in salaries and expenses for things like State Police, corrections officers, and state parks.

State reimbursements to hospitals, for charity care or payments for health care services for pregnant women and seniors, are vital to the financial stability of our hospitals, which are among the state's biggest employers and a growing part of our overall economy.

### Government Spending Strengthens a Weak Economy More Than Tax Cuts

When the economy stumbles, states often find themselves in financial trouble as tax collections fall. To balance their books, states often have two choices: cut spending and programs, or raise taxes or other fees. When tax cuts are enacted to stimulate the economy, the budget cuts have to be more severe to maintain budget balance.

According to Nobel Prize winning economist Joseph Stiglitz, raising taxes on high-income households and increasing spending during an economic downturn is less harmful to the economy than cutbacks in state government programs. This is because state governments inject all the money they collect back into the economy, while a good part of any reduction in taxes is saved by higher-income families and generates no economic activity.

A separate study found that when Michigan needed to close a \$1 billion budget deficit, reducing state investments would have cost almost 24,000 jobs — 46% of them in the private sector.



## Section III: State Taxes

Just like family income, state income needs to be stable and adequate, so government can provide services efficiently and reliably. Without stable and adequate revenue, states lurch from fiscal crisis to fiscal crisis, funding services one year and cutting them the next.

Tax policy experts know that the most stable tax system doesn't rely too much on one type of tax. Pennsylvania's main state taxes are a personal income tax, a sales tax, and a number of business taxes. Different states use different mixes of taxes. A few states have no personal income tax, and some have a state property tax in addition to local property taxes. Businesses and individuals pay corporate, sales, and property taxes.

Different taxes grow at varying rates and respond differently when the economy grows or shrinks. Compared to relying on a single tax, the combination of sales, personal income, and corporate taxes creates a system in which tax collections increase at a moderate yet steady rate.

In the long term, if tax systems rely too heavily on taxes that do not keep up

with economic growth, governments must raise tax rates more frequently and/or offer fewer services.

Each tax has a rate and a base. Pennsylvania's personal income tax rate is 3.07%, and the base — the money that is taxed — is income from wages, investments, and business activity. In general, the broader the tax base is, the less the tax rate must be to raise the same amount of revenue.

For example, Pennsylvanians pay sales taxes on most tangible goods and a few services. These goods and services are the tax base. The sales tax rate is 6% of the purchase price. If the sales tax base included all goods and services in Pennsylvania, a lower tax rate could raise the same amount.

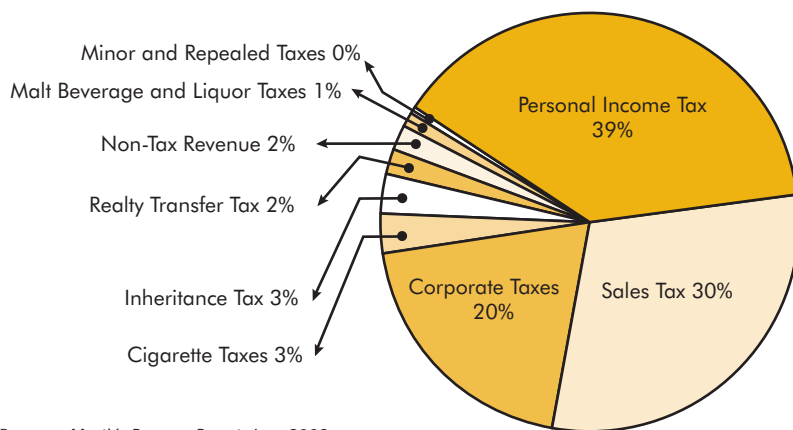
The personal income tax (PIT) is the largest single tax in Pennsylvania's state tax system.



## Pennsylvania State Taxes

The state General Fund pays for most state programs. Its revenue sources include most state taxes, fees from services, and other income, such as state liquor store profits. Almost 90% of General Fund money comes from three sources: personal income taxes, sales taxes, and corporate taxes.

General Fund Revenue Sources, 2007-08 Total Revenue: \$27.9 Billion



Source: Pennsylvania Department of Revenue, *Monthly Revenue Report*, June 2008.

### Personal Income Tax

Type of Tax:	Income
Taxpayers:	Individuals, businesses, & farms
Rate:	3.07% of taxable income
Number of taxpayers:	5.7 million
Tax Collected:	\$10.9 billion

**The personal income tax (PIT) is the largest single tax in Pennsylvania's state tax system.** It has a wide base — the earnings of individuals from eight defined categories or "classes" of income: wages, business or farm net profits, interest income, dividend income, property sales, estate or trust income, gambling winnings, and royalties, rents or copyrights. If income does not fit into these specific classes, such as pension income, it is not taxed. Compared to the fed-

eral personal income tax, Pennsylvania PIT has few deductions or credits.

**The PIT has a low, flat rate.** The 3.07% PIT rate is the second-lowest top income tax rate in the U.S., after Illinois. It is also flat, meaning that everyone pays the same rate, whether they earn \$25,000 or \$25 million. Many states have a progressive income tax, which would tax higher-income earners at higher rates. The Uniformity Clause of the Pennsylvania Constitution requires that each kind of income (e.g., wage income) be taxed at the same rate and has thus far prevented Pennsylvania lawmakers from enacting a progressive income tax. There are some ways to make Pennsylvania's personal income tax more progressive without a constitutional amendment, for example by taxing kinds of income (e.g., income from the sale of property or securities) that is primarily earned by higher-income taxpayers at a higher rate.



**Tax Forgiveness makes the personal income tax more fair.** The state Constitution does permit special exemptions for persons affected by age, disability, infirmity, or poverty. The PIT Tax Forgiveness program is targeted towards the elderly and the poor. The state Tax Forgiveness program exempts PIT liability for lower-income individuals and families based on income, marital status, and number of children. In 2008, a working family of four earning \$32,000 received a tax refund equal to its state taxes, about \$980.

While Pennsylvania's Tax Forgiveness program exempts 1.3 million families from PIT, some states go farther, with a state earned income tax credit that is based on the federal Earned Income Tax Credit (EITC). The federal EITC provides very low-income working families with a refundable tax credit that can exceed their income taxes paid, which helps to offset the cost of payroll taxes and to move these families out of poverty.

With a refundable tax credit, the taxpayer receives more back in a refund than he or she pays in taxes. The EITC program is an income subsidy that comes in the form of a tax credit.

**Pensions and Social Security are not taxed.** Pennsylvania senior citizens have very generous tax exemptions. The Commonwealth is one of only seven states that exempt all Social Security and pension income from personal income taxes. This exemption makes sense for seniors with lower, fixed incomes. However, this exemption is unlimited, so a retired executive with a \$250,000 pension gets a bigger break

than a retired janitor earning a \$12,000 pension. In addition, many Pennsylvania seniors do not pay PIT on their non-retirement income because of the Tax Forgiveness program.

**Pennsylvania's personal income tax is unique.** Most states base their income taxes on the federal income tax. Pennsylvania does not. Pennsylvania's income tax is unusual in several important ways:

- The tax is levied on eight specific income classes, and losses in one class can't offset another. For example, if you lose money in the stock market, you can't use the loss to lower the taxes on your earnings.
- Losses from one spouse cannot offset gains from the other spouse, even within the same class of income.
- There are considerably fewer deductions and credits than at the federal level. With the exception of Tax Forgiveness, most taxpayers pay tax on all of their income. For example, a family of four with an income of \$40,000 pays the 3.07% income tax on every penny of that \$40,000.
- Money paid by employees into retirement accounts or pensions is taxed when the money is deposited. The federal government does not tax most of these payments until retirement. On the other hand, Pennsylvania doesn't tax retirement or pension benefits.

With a refundable tax credit, the taxpayer receives more back in a refund than he or she pays in taxes.



**Many small businesses pay the personal income tax instead of corporate net income tax.**

Businesses that are organized as sole proprietorships, partnerships, limited liability corporations, and corporations with a small number of stockholders, known as subchapter S-corporations, pay taxes at the 3.07% rate rather than the corporate rate of 9.99%. They are known as “pass-through” businesses because the income of the business is passed through to the owners, who pay tax on it.

While pass-through businesses include many small businesses, they are not necessarily small. Very large businesses can be set up as pass-throughs. In recent years, the most rapidly growing type of pass-through business is the limited liability company (LLC). LLCs have the best of both worlds — the lower taxes of a pass-through business and the liability protection of a corporation. It has even become commonplace for major corporations to form their subsidiaries as LLCs.

Because Pennsylvania has such a low top personal income tax rate and a higher corporate income tax rate at 9.99%, businesses have an incentive to form as pass-through businesses. For example, in West Virginia, the top personal income tax rate of 6.5% is close to the corporate income tax rate of 8.5%, which creates less of an incentive for companies to change their corporation status.

**HOW WIDGET WORKS AVOIDS PAYING CORPORATE TAXES**

Widget Works: Net income subject to Pennsylvania tax	\$10,000,000
If incorporated as an S-corporation, the owners of Widget Works pay 3.07% PIT on Widget Works income	\$307,000
If incorporated as a regular corporation, Widget Works pays the 9.99% Corporate net income tax	\$999,000
Difference in taxes paid	\$692,000

**JARGON ALERT:** S-corporation is a U.S. corporation with 100 or fewer shareholders that chooses this distinct form of organization with the IRS or the Pennsylvania Department of Revenue. Generally, an S-corporation is exempt from federal corporate income tax and Pennsylvania corporate net income tax.

Instead, the income of the corporation flows to the S-corporation’s shareholders. The shareholders include their share of the corporation’s income on their individual tax returns, often at lower tax rates.



## Sales and Use Tax

Type of Tax:	General sales and use
Taxpayers:	Households and businesses
Rate:	6% of the purchase price of taxable goods and services
Number of taxpayers:	4.8 million households and businesses
Tax Collected:	\$8.5 billion

**Pennsylvania's sales tax is an important revenue source.** About one-third of General Fund revenue comes from sales taxes. Individuals and families account for 64% of the sales tax paid in Pennsylvania. Businesses pay the rest.

**Pennsylvania's state sales tax is comparable to other states.** Our state sales tax rate is 6%, which is around what other states impose. State law allows Philadelphia and Pittsburgh to charge an additional 1%.

In many other states, local governments can impose a sales tax, bringing total sales taxes up to 8.25% in some cities in Texas, for example.

**Sales tax is levied on most goods and a few services.** Pennsylvanians pay no sales tax on most food, clothing, and shoes. Our sales tax also exempts prescription and non-prescription drugs and medical supplies, residential utilities, doctor and dentist fees, professional services, (like accounting or legal fees), and some personal hygiene products like toothpaste.

**The sales tax has not kept up with the changing economy.** Since 1970, households are spending less of their income on durable and non-durable goods that are typically subject to sales tax, while

spending a higher share on services, many of which are not taxed. In addition, sales tax is often not collected from items purchased on the Internet if the seller is not located in Pennsylvania. When this happens, the buyer should pay the use tax directly to the state, but most individuals are not aware of this obligation. This creates a disadvantage for local retailers.

**State law exempts a whole host of specific and curious items and services from sales tax.** These include body piercing and tattooing, bottled water, candy and gum, caskets, firewood, hair-restoring medicines, magazine and newspaper subscriptions, textbooks, horses sold out of state, pony rides, stair-lift devices, and tanning bed fees. Each session, the legislature considers bills that would exempt specific goods or services from sales tax. Individual legislators and industry lobbyists push for these exemptions. This erodes the sales tax base and further keeps it from growing with the economy.

**Sales taxes are regressive.** The sales tax absorbs more of a lower-income family's budget than an upper-income family's, making it regressive. Lower-income families spend more of their money on consumable goods than higher-income families and can't save or invest that portion of their income. The state does not tax many luxury services that higher-income families are likelier to buy.

Individuals and families account for 64% of the sales tax paid in Pennsylvania.





Here is an example:

Family A with an income of \$25,000 buys a car for \$13,000. Family B earns \$250,000 and buys a much nicer car for \$60,000. As this shows, Family A pays much more of its income in sales tax on this single, large purchase.

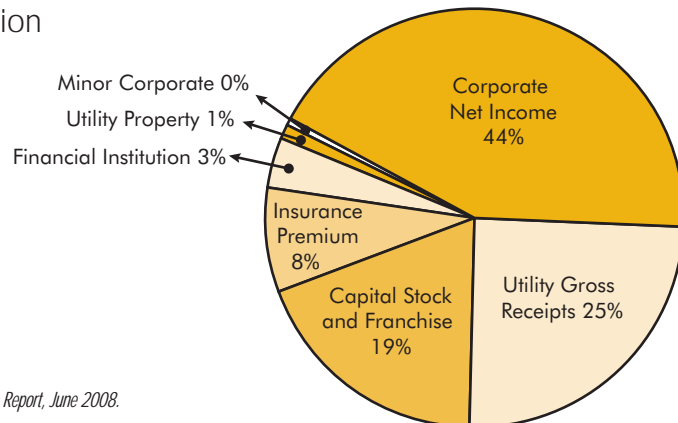
	Family A	Family B
Annual Income	\$25,000	\$250,000
Price of Car	\$13,000	\$60,000
6% Sales Tax Paid on Car	\$780	\$3,600
Portion of Income Paid in Tax	3.1%	1.4%

## Corporate Taxes

Corporate taxes account for 20% of General Fund revenue. Almost 90% of corporate taxes come from three sources: corporate net income tax, capital stock & franchise tax, and the gross receipts tax.

### Corporate Taxes by Type, 2007-08

Total Revenue: \$5.5 Billion



Source: Pennsylvania Department of Revenue, *Monthly Revenue Report*, June 2008.

### Corporate Net Income Tax

Type of Tax:	Income
Taxpayers:	C-corporations (except banks and insurers)
Rate:	9.99% of taxable net income attributed to Pennsylvania
Number of taxpayers:	130,000 corporations file, 38,000 of these pay tax (2004)
Tax Collected:	\$2.4 billion

The corporate net income tax (CNIT) accounts for nearly half of all corporate tax collected by the state. Corporations pay 9.99% on their net earnings (profits left over after expenses). The CNIT has the nation's second-highest state corporate income tax rate, but a somewhat leaky tax base.

**Corporations only pay CNIT on net earnings or profits earned in Pennsylvania.** A corporation is subject to the CNIT if it is doing business in, having property or capital used in, or owns property in Pennsylvania. The income a company

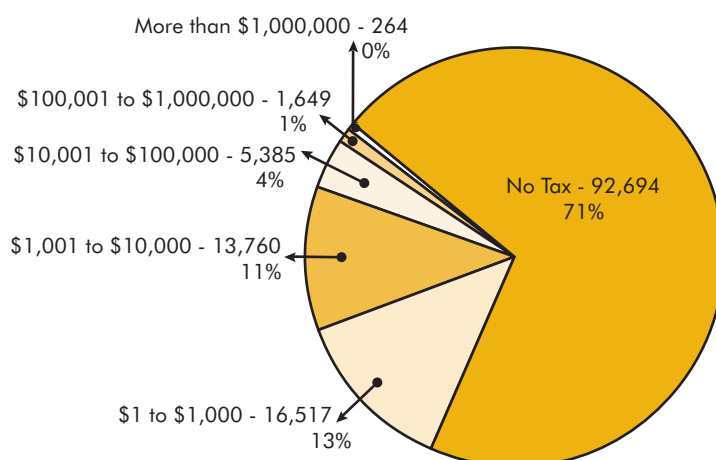


pays tax on is based on its federal income tax return, with some required additions and deductions specific to Pennsylvania.

**Corporate income taxes are particularly volatile.** Corporate profits are different by industry and change significantly with the economy, growing quickly in good years and falling steeply in bad years. This makes the CNIT less stable than sales or property taxes.

**Few companies pay the corporate net income tax.** In 2004, 71% of all corporations that filed returns paid no net income tax, and only 5.6% of 130,000 filing corporations paid more than \$10,000.

### 71% of Corporations Filing in Pennsylvania Pay No Corporate Net Income Taxes



Source: Pennsylvania Department of Revenue, *Tax Year 2004 Statistics on Capital Stock/Franchise Tax and Corporate Net Income Tax*.

**Three normal factors contribute to the large share of companies without any Pennsylvania tax liability:**

- Corporations might be unprofitable in a given year.
- Otherwise profitable corporations may be able to use deductions for losses in a previous year to reduce their state taxable income to zero.
- Corporations come and go, and unless a corporation liquidates its assets and asks to be taken off the tax rolls, it must file tax returns even if it had no activity that year.


**A fourth factor that reduces CNIT collections is that Pennsylvania's antiquated tax reporting system allows companies to easily manipulate income.** For federal taxes, companies usually file a single report covering all activity of their companies and subsidiaries

Because Pennsylvania has such a low top personal income tax rate and a higher corporate income tax rate businesses have an incentive to form as pass-through businesses.



as if they were one company. In contrast, Pennsylvania requires companies to file a separate return for each company and subsidiary, making it easier for companies to hide income. How do they hide income? They move income from high-tax states to lower-tax states by buying or selling things among the related companies.

Pennsylvania's archaic way of filing is based in a time when most corporations were stand-alone companies. That is less often the case today, as many corporations are subsidiaries of larger conglomerates or linked in other ways with larger organizations which share some of the same owners or shareholders.

 **IDEA!** Adopt Combined Reporting. Other states have seen the mismatch between the reality of complex corporate structures and the separate company tax filing system and have adopted a more modern system called combined reporting, under which affiliated corporations calculate their tax as if they were one entity. This eliminates transactions within the group and makes it harder for corporations to avoid taxes in a specific state. Combined reporting was developed more than 60 years ago and has been adopted in 22 states.

## Capital Stock and Franchise Tax (CSFT)


Type of Tax:	Property tax on capital stock value
Taxpayers:	C and S-corporations, limited liability companies, and business trusts
Rate:	2.89 mills (tax year 2008)
Number of taxpayers:	315,000 businesses file, 95,400 of these pay tax (2004)
Tax Collected:	\$1.0 billion

**The capital stock and franchise tax, or CSFT, taxes a corporation's average net income over five years and its net worth.** Companies can exempt \$250,000 of their value, reducing the tax's impact on small corporations. Property used in manufacturing, processing, research and development, and pollution control in Pennsylvania may be excluded from taxation — a big break for Pennsylvania's manufacturers. **CSFT accounted for 19% of all corporate tax collections in 2007-08.**

**The tax is being eliminated.** The CSFT rate has been cut gradually since 1997, when it was 12.75 mills (a mill is equal to one tenth of one percent). The current rate is 2.89 mills, meaning that a company would pay \$2.89 for each \$1,000 of capital stock value attributed to Pennsylvania. After the elimination of CSFT, S-corporations and LLCs will not be subject to a corporate tax in Pennsylvania.

Businesses dislike this tax, which they view as a disincentive to invest in Pennsylvania, and because it is owed whether or not the business earned a profit in a given year.

**The tax has its good features.** It brings in significant revenue to the state, even though the rate falls each year. The portion of the tax that depends on net worth ordinarily smooths out year-to-year changes, making it more stable. Unlike the CNIT, this tax is difficult to avoid.

 **IDEA!** To ensure that all corporations operating in Pennsylvania contribute a fair and reasonable amount toward the cost of government services, a minimum tax could be employed. It could be the greater of the corporation's potential CNIT or CSFT liability at a specific, low millage rate. Thirteen states have a minimum business tax, but the amounts are small, ranging from \$10 to \$800.

## Gross Receipts Tax

Type of Tax: Excise tax on gross receipts

Taxpayers: Pipeline, freight and passenger transportation, telephone, mobile communications, electric utilities, and private bankers

Rate: Varies by industry

Tax Collected: \$1.3 billion

The gross receipts tax is levied on pipeline, transportation, and utility (e.g., telecommunications, cable, and electricity) companies. The gross receipts tax operates like a sales tax, which customers pay directly through a surcharge on their bills.

The gross receipts tax has been updated to reflect new services. In 2003, the gross receipts tax was levied on cell phone service and inter-state calls.

## Other Corporate Taxes

Taxpayers: Financial institutions and insurance companies

Rate: Varies by tax type

Tax Collected: \$610.0 million

Banks and insurance companies each pay specialized taxes, instead of corporate net income tax and capital stock and franchise tax. Commercial banks pay a tax similar to the CSFT, which is 1.25% of share value. Savings banks pay a mutual thrift tax of 11.5% of net income, and credit unions do not pay a corporate tax in Pennsylvania. Most insurance companies pay a 2% premiums tax, instead of the corporate income or stock tax.

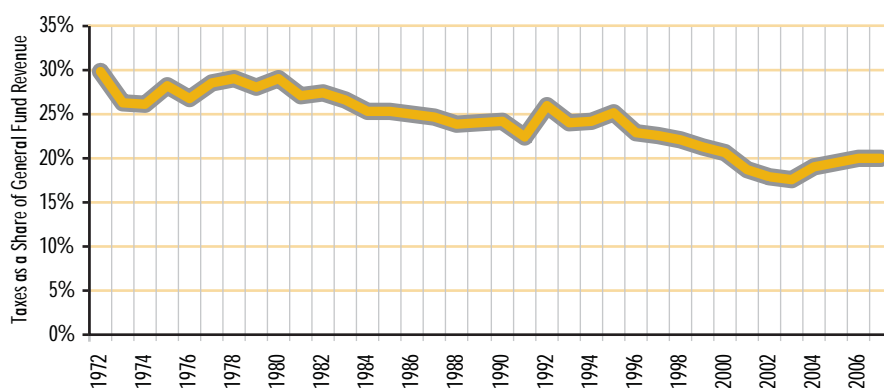
Over time, corporate taxes make up a smaller share of General Fund revenue. As in most states, corporate income is a declining source of state tax revenue, largely due to reductions in business tax rates and special tax exemptions. Pennsylvania has cut business taxes more than \$1 billion since 1997.

The declining corporate share of taxes is problematic. Corporations, like individuals, use public goods like transportation, education, and environmental remediation services that are paid for with tax dollars. Reducing corporate taxes shifts the responsibility for these services to other taxpayers.

It also makes our revenue system more unstable.

Pennsylvania requires companies to file a separate return for each company and subsidiary, making it easier for companies to hide income.

Corporate Taxes are Providing a Smaller Share of General Fund Revenue Over Time



Source: Pennsylvania Department of Revenue, Bureau of Research, *The Statistical Supplement to the Tax Compendium*, various years.

## Cigarette, Gasoline and Alcohol Taxes

Type of tax:	Excise
Taxpayers:	4.8 million households and businesses
Rates:	Vary by product
Tax Collected:	\$2.3 billion

An excise tax is a special tax levied on the purchase of a specific product. In Pennsylvania, these products include alcohol, tobacco, gasoline, and diesel fuel.

**Taxes on cigarettes, beer, wine, and liquor are often called “sin taxes.”** These are easier taxes to raise because consumption of these items is voluntary, and the tax often affects a small portion of the population. Unfortunately, these taxes are often paid disproportionately by the poor.

**Excise taxes raise a substantial amount of money.** In 2007-08, the cigarette tax raised \$784 million and the liquor tax and malt beverage taxes raised \$277 million. The largest of these, the motor fuels taxes, raised \$1.2 billion.

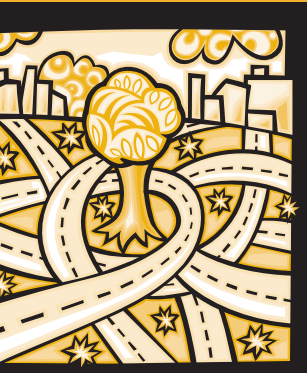
**Consumption is sometimes sensitive to price, which can affect tax collections.** Consumption of cigarettes typically declines when the cigarette tax increases. When the price of gasoline rises, people drive less, and fuel tax collections drop. Declining oil use is good for the environment, but declining fuel tax revenue reduces funding for road and bridge maintenance and repair. In 2007-08, fuel tax revenue declined by 1.5% even though overall tax revenue grew by 2.5% over the previous year.

Pennsylvania’s excise taxes have features that make them unique:

- Pennsylvania’s cigarette tax is \$1.35 per pack. This ranks 19<sup>th</sup> in the U.S. in 2008, significantly below New Jersey’s \$2.57

per pack, much more than West Virginia’s 55 cents per pack, and roughly equal to Pennsylvania’s other neighbors. However, Pennsylvania is the only state in the nation that exempts smokeless tobacco products from the excise tax.

- Separate fuel taxes are levied on gasoline and diesel in Pennsylvania. State gasoline taxes add a fixed 31.2 cents to a gallon of gasoline, while diesel taxes add a fixed 38.1 cents per gallon. These are some of the higher state fuel tax rates in the country. Fuel taxes are regressive, taking more of the income of lower-middle-income families than more affluent ones.
- Beer drinkers pay the malt beverage tax which amounts to about a penny for a pint of beer. The liquor tax is also called the Johnstown Flood tax because it was first enacted to provide financial assistance to the victims of the 1936 flood. Today the revenue from the tax goes into the General Fund.





## Other General Fund Taxes

The **inheritance tax** is paid by the estate of someone who passes away. It is paid on the net value of property in Pennsylvania that is transferred to other people. The tax rate depends on who gets the property. Property given to a spouse or from a minor child to a parent is not subject to inheritance tax. Property given to grandparents, parents, children, and grandchildren is taxed at 4.5%, slightly more than the rate on ordinary income. Property given to siblings has a 12% rate, and all other transfers have a 15% rate. Property given to charitable organizations or governments is exempt from tax.

The inheritance tax raises over \$800 million per year — about equal to the cost of running half of the state's 26 prisons.

The **realty transfer tax (RTT)** is a 1% tax on the property value of commercial or residential real estate in Pennsylvania. Most counties also impose an additional 1% tax. Philadelphia, Pittsburgh, Reading, and Scranton impose a local RTT with a rate that is as high as an additional 3%. RTT collections vary as the real estate market expands and contracts. For example, state General Fund RTT collections grew from \$290 million in 2000-01 to \$552 million in 2005-06 with the rise in housing prices, but declined to \$429 million in 2007-08 when home sales and prices fell.

Pennsylvania has cut business taxes more than \$1 billion since 1997.



## Section IV: Local Taxes

Pennsylvania has a large number of local governments, including 2,566 municipalities, 67 counties, and 501 school districts. A taxpayer may pay taxes separately to a municipality (a township, borough, or city), a county, and a local school district.

Pennsylvania's local governments and school districts rely more on the property tax than any other tax. Unlike many other states, local governments in Pennsylvania may also use local income taxes and business taxes. Allegheny and Philadelphia are the only two counties that have a local sales tax.

### Property Taxes

**Property taxes are the primary funding source for counties and school districts and a major revenue source in municipalities.** In 2005-06, local school districts raised \$10 billion through the property tax, while counties and municipalities raised just over \$4.1 billion.

**Individuals and businesses pay property taxes.** Both homeowners and business owners pay real estate taxes. Because of the Uniformity Clause of the state Constitution, the rate on each is the same. Unlike many other states, Pennsylvania law does not permit business

equipment to be taxed as part of the property. This is a significant benefit to businesses.

**Local governments rely heavily on property taxes, which represented 71% of local tax revenue in 2005-06 — comparable to the U.S. average and slightly lower than in similar, competitor states.** Local governments may also levy taxes on earned income, a per-person fee (the per capita tax), occupations, amusements, parking, hotels, and realty transfers, plus business licenses and taxes.

**Like other taxes, the property tax has a base and a rate.** The tax base is the assessed value of real estate (both land and buildings). Tax assessment is done on a county-by-county basis and is ordinarily based on some percentage of the market value of the property.

**Some counties conduct property tax assessments regularly and some do not.** Blair County has not reassessed property since 1958. York County reassesses property once every three years. This keeps the assessed value closer to the current market value.



**The other half of the property tax equation is the tax rate.** Tax rates are expressed in mills. A mill is \$1 in tax per \$1,000 of assessed value, or one-tenth of one percent. The tax is calculated by multiplying the assessed value of the property by the tax rate. Tax rates are determined each year by counties, school districts, and municipalities, based on their revenue needs.

**The value of much of Pennsylvania's property is exempt from taxation.** For example, properties owned by the federal, state, or local governments don't pay property taxes. In addition, churches and other purely public charities, including many hospitals and universities, are generally exempt from paying property tax. In some areas, exempt properties severely reduce the tax base. For example, 30% of Reading's property and 48% of Harrisburg's are exempt from taxation. It's not just a problem in cities. In northern Pennsylvania, state and federal forest lands take a big bite out of the tax rolls.

**Property taxes are uneven across localities and school districts.** Property wealth

is not evenly distributed throughout Pennsylvania. School districts and municipalities with high property wealth can finance their schools and governments with relatively low tax rates. Areas with less wealth or a lot of tax-exempt properties, such as Reading and Harrisburg, have to tax what properties they can at much higher rates. These varying tax levels and resources increase the inequity between school districts.

**Property taxes on a mid-priced home in Pennsylvania (\$145,200) can vary by more than \$3,000 from one district to the next.** In Allegheny County, that \$145,200 home in the affluent Fox Chapel School District is taxed at \$3,441, but in the poorer Wilkinsburg School District, it's taxed at \$6,563.

**It is not uncommon for poorer communities to have higher school property tax rates.** The figure below looks at tax rates in two school districts in six counties. Except for Berks County, the school district in each county with higher child poverty rate — the poorer district — has higher millage rate.

County	School District	Millage Rate	Projected Tax	Child Poverty Rate (2000)
Allegheny	Fox Chapel SD	23.7	\$ 3,441	8%
Allegheny	Wilkinsburg SD	45.2	\$ 6,563	32%
Berks	Twin Valley SD	19	\$ 2,759	7%
Berks	Antietam SD	31.1	\$ 4,516	6%
Chester	Tredyffrin-Easttown SD	12.6	\$ 1,830	3%
Chester	Coatesville Area SD	24.8	\$ 3,601	12%
Delaware	Marple Newtown SD	13.6	\$ 1,975	4%
Delaware	William Penn SD	35.8	\$ 5,198	14%
Mercer	Lakeview SD	13	\$ 1,888	15%
Mercer	Sharon City SD	23.4	\$ 3,398	26%
Montgomery	Colonial SD	13.5	\$ 1,960	3%
Montgomery	Pottstown SD	32.1	\$ 4,661	14%

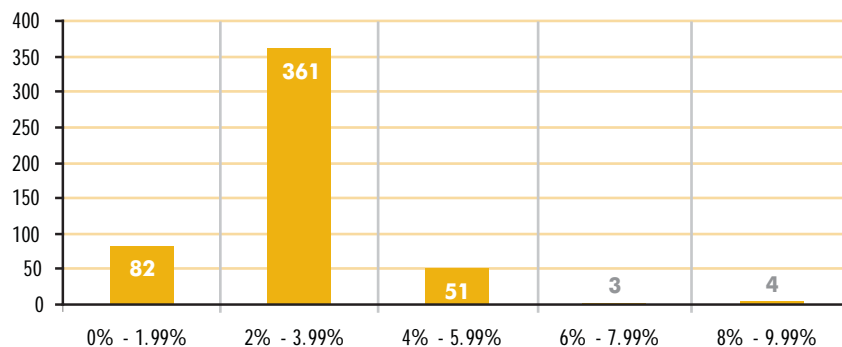
Local governments rely heavily on property taxes, which represented 71% of local tax revenue in 2005-06.





By many measures, property taxes in Pennsylvania are not high, but they remain highly unpopular. Property taxes on residential property as a share of personal income range from 0.9% to 9.7% for Pennsylvania's 501 school districts, with school property taxes averaging 3.1% of personal income across the state.

### 88% of Pennsylvania's School Districts, Taxpayers Pay Less than 4% of Their Personal Income in School Property Taxes



Source: Pennsylvania Budget and Policy Center calculations of real estate taxes on residential properties based on Pennsylvania Department of Education and Pennsylvania State Education Association data.

### Why don't people like property taxes?

- Property taxes are paid in a lump sum. Income taxes and sales taxes are often a greater share of income, but because they come out bit-by-bit, they're less noticeable.
- Property taxes are not based on ability to pay. Working homeowners may be able to afford the taxes on their properties until they lose their jobs or suffer pay cuts. Retirees may have trouble paying property taxes because property values may rise while their incomes do not.
- Property taxes are rising. Nationally property taxes have declined as a share of total state and local revenue since 1977, falling from 35.5% to 30%. Over the same time, Pennsylvania property taxes have increased as a share of all taxes from 26% to 29%.





## Section V:

### State Comparisons: Pennsylvania Spending and Taxes are Moderate

Pennsylvania is a large state that collects a lot of money — sixth in population, and fifth in the size of its state budget. But total income and spending based simply on population don't tell much about how Pennsylvania compares to other states.

U.S. Census Bureau figures paint a fuller picture of state tax and spending and allow meaningful comparisons across states.

#### State Comparisons of Tax Levels Should Take into Account State Income Levels

A good way to evaluate relative tax and spending levels is to look at **state spending or taxation as a share of state personal income**. To calculate state personal income, add all of the wages, salaries, employer-contributed pensions and insurance, business earnings, rental earn-

ings, dividends, and interest that are received by a state's residents.

**Pennsylvania's state personal income has increased steadily since 1960.** Our growth has differed from that of our neighbors — lower overall than New Jersey, but higher than West Virginia.

Our state personal income tends to grow more slowly because we have a slow-growing population. Our population grows slowly because we have a high percentage of elderly, a low percentage of children, and minimal migration into the state.

**A second measure is per-capita or per-person spending or taxes, which takes**

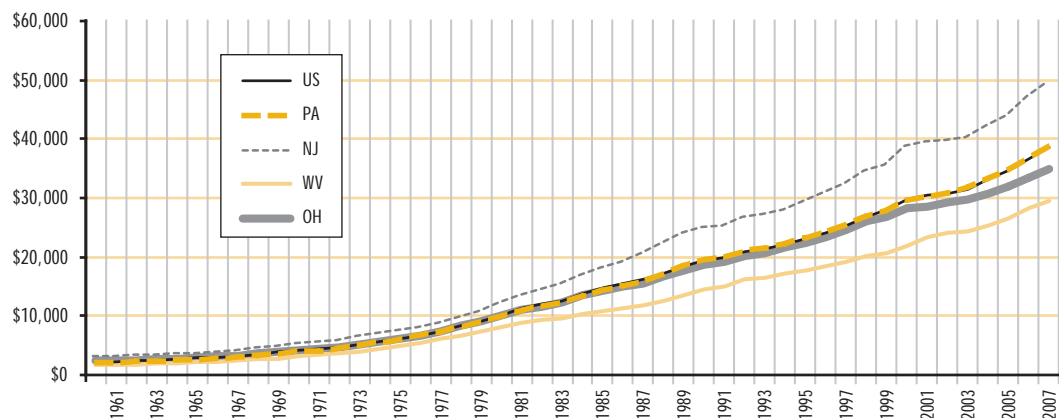
Pennsylvania's state personal income has increased steadily since 1960.



**population out of the equation.** In 2007, Pennsylvania's personal income per person was \$38,788, slightly more than the national average of \$38,611. That puts Pennsylvania 19<sup>th</sup>-highest nationally.

Pennsylvania per-capita personal income has stayed close to the national average since 1960, departing from the national figure by no more than 2% each year. Demographic factors affect the growth of personal income per capita just as they do total personal income growth. A growing share of working-age adults in a state's population, and significant in-migration of high-income working-age adults, will accelerate growth in state personal income.

### Unlike Some of Our Neighbors, Pennsylvania Mirrors U.S. Per Capita Personal Income Over Time

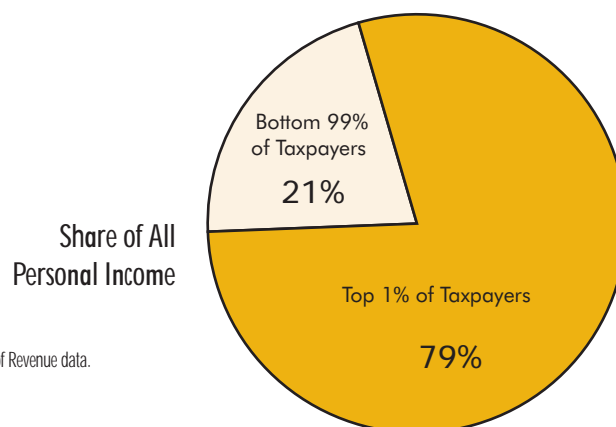


Source: Regional Economic Information System, Bureau of Economic Analysis, U.S. Department of Commerce.

Personal income has grown steadily over time, but data reported on Pennsylvania personal income tax returns suggest that the growth has been concentrated at the top. The average taxable income of the bottom 90% of Pennsylvania taxpayers fell by 4% between 2001 and 2005, while the average taxable income of the top 10% increased by 16%. And while real personal income grew in Pennsylvania by 6% between 2001 and 2005, the top 1% of taxpayers captured nearly 80% of this growth.

The average taxable income of the top 1% of taxpayers rose by nearly \$250,000 between 2001 and 2005, an increase of 31%.

### The Wealthiest 1% of Taxpayers Captured Nearly 80% of All Personal Income Growth, 2001-2005



Source: Keystone Research Center analysis of Pennsylvania Department of Revenue data.

## How Does Pennsylvania's Spending Compare to Other States?

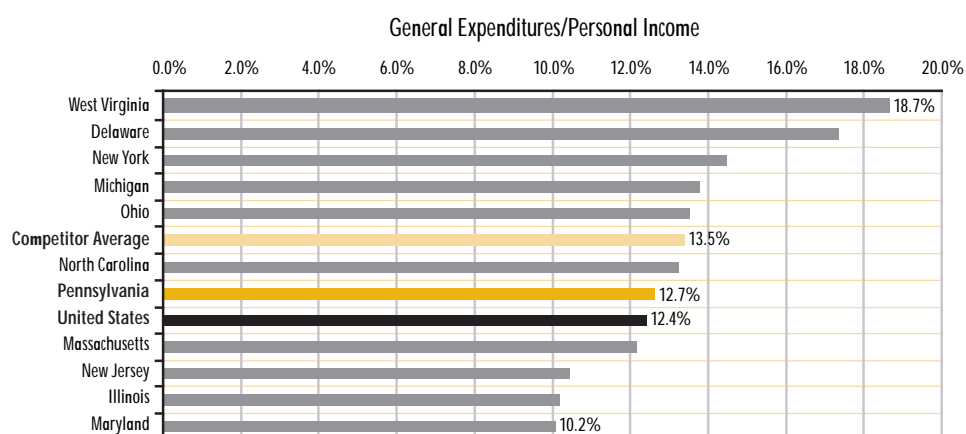
Pennsylvania in Brief (2005):

Category	Value	U.S. Rank
Total General State Expenditures <sup>1</sup>	\$54.9 billion	5 <sup>th</sup>
State Expenditures as Share of Personal Income	12.7%	30 <sup>th</sup>
Total State Taxes	\$27.2 billion	5 <sup>th</sup>
State Taxes as Share of Personal Income	6.3%	32 <sup>nd</sup>

Pennsylvania state spending is in the lower half of all states. As a share of state personal income, Pennsylvania state spending ranks 30<sup>th</sup> overall. While we fall just above the national average, we are well below the average of competitor states, which include neighboring states and other large manufacturing states.

States like New Jersey and Massachusetts have very high personal income, so state spending looks smaller in comparison. Pennsylvania's personal income is just above the national average, and our spending is too.

### Pennsylvania's General State Expenditures as a Share of Personal Income are Roughly Equal to the U.S. Average, 2005



Source: The Urban Institute-Brookings Institution Tax Policy Center. State & Local Government Finance Data Query System. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments.

<sup>1</sup> General State Expenditures measures state government spending with limited exceptions, and includes federal funds. Total state taxes includes only those taxes imposed by state governments and excludes federal funds.

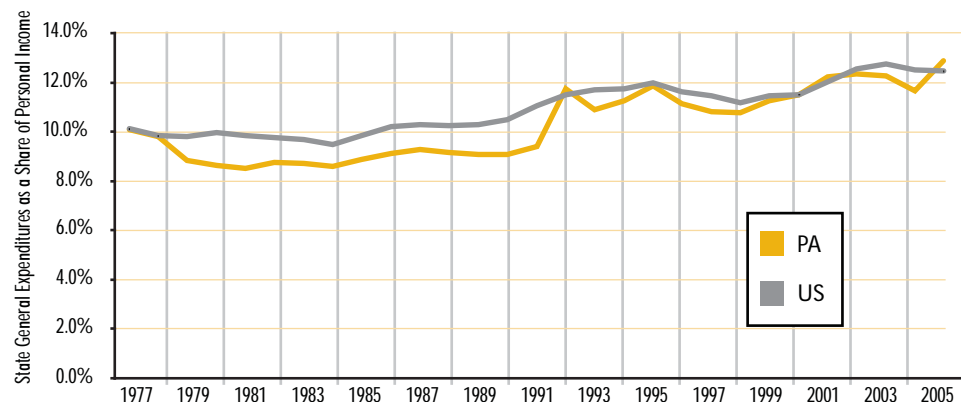
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## Pennsylvania Spending Over Time

State government spending in Pennsylvania, as a share of personal income, has been below the national average for 27 of the last 30 years. This includes four out of the last six years.

### Pennsylvania's General Expenditures Are Generally Lower than the U.S. Average Over Time

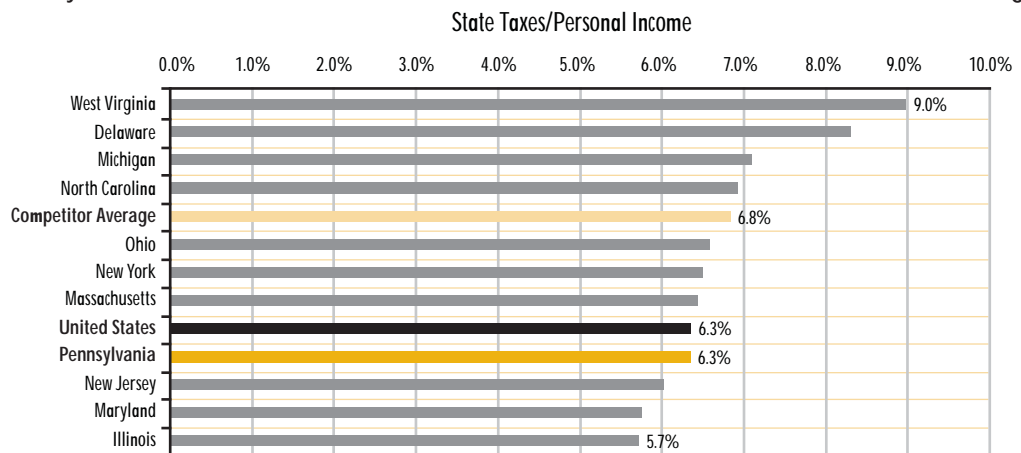


Source: Regional Economic Information System, Bureau of Economic Analysis, U.S. Department of Commerce.

## How Do Pennsylvania's Taxes Compare?

In 2005, Pennsylvania's state total tax collections ranked fifth in the U.S. **However, when measured as a share of personal income, Pennsylvania state taxes are average compared to other states.** All together, Pennsylvania's taxpayers pay about 6% of their personal income in state taxes. That's slightly less than the U.S. average and ranks Pennsylvania 32<sup>nd</sup> among states. Residents of competitor states pay, on average, one half of a percent more of their total personal income in state taxes.

### Pennsylvania State Taxes as a Share of Personal Income are on Par with the National Average, 2005



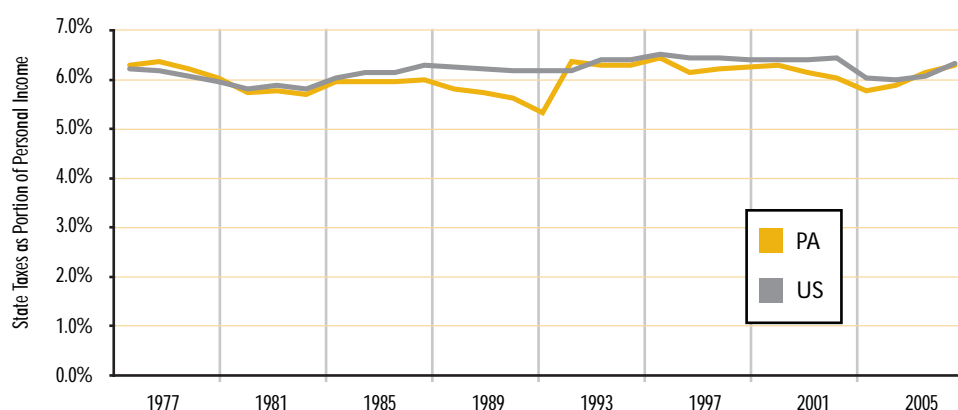
Source: The Urban Institute-Brookings Institution Tax Policy Center. State & Local Government Finance Data Query System. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments.



## Pennsylvania State Taxes Have Remained Near the National Average

For decades, Pennsylvania has remained in the middle of the pack in terms of state taxes. As three decades of data from the U.S. Census Bureau show, Pennsylvania closely tracks national averages in the portion of personal income paid in taxes.

### Pennsylvania's State Taxes Increase Too Quickly? A Comparison to the U.S. Average Over Time Shows These Claims are Not True



Source: The Urban Institute-Brookings Institution Tax Policy Center. State & Local Government Finance Data Query System. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments.

## Pennsylvania State and Local Government Taxes and Spending

### Pennsylvania State and Local Governments in Brief (2005)

Category	Value	Share of PI	U.S. Rank
State General Expenditures	\$54.9 billion	12.7%	30 <sup>th</sup>
State and Local Expenditures	\$87.5 billion	20.3%	24 <sup>th</sup>
Total State Taxes	\$27.2 billion	6.3%	32 <sup>th</sup>
State and Local Taxes	\$46.0 billion	10.7%	21 <sup>st</sup>

Every state shares some of its taxing and spending authorities with local governments. How much a state chooses to share these functions can make a tremendous difference in the relative levels of state and local taxation. For example, in New York, county governments contribute directly to the state share of Medicaid; in Pennsylvania, the state pays the costs with no local contribution. On the other hand,

All together, Pennsylvania's taxpayers pay about 6% of their personal income in state taxes.

Hawaii's state government funds the entire cost of education, while Pennsylvania pays only one-third of the costs and local school districts pay the rest.

**Pennsylvania relies more on local spending than other states.** Pennsylvania state and local government expenditures were 20.3% of state personal income in 2005 which is slightly higher than the national average and our competitor states. While the Commonwealth ranks 30<sup>th</sup> nationally in state-only spending, we rank 24<sup>th</sup> in combined state and local expenditures.

**Pennsylvania relies more on local taxes than other states.** While the Commonwealth ranks 32<sup>nd</sup> in state taxes relative to personal income, it ranks 21<sup>st</sup> in combined state and local taxes as a share of personal income. Still, Pennsylvania state and local taxes are lower than four of six neighboring states and lower than the U.S. average.

**Pennsylvania's high reliance on local taxes suggests state taxes may be too low, forcing local governments and school districts to raise local taxes to provide basic services.** A high reliance on local taxes can lead to big differences in local tax rates between wealthy and poor communities, and to lower-income families paying higher tax rates than wealthy ones.

**Pennsylvania's total tax share hasn't changed much over time, increasing from 9.9% in the 1980s to 10.4% in this decade.** We still rank in the middle of all states.

#### STATE AND LOCAL TAXES AS A SHARE OF PERSONAL INCOME

1980-1989		1990-1999		2000-2005	
Amount	Rank	Amount	Rank	Amount	Rank
9.9%	27	10.3%	31	10.4%	29

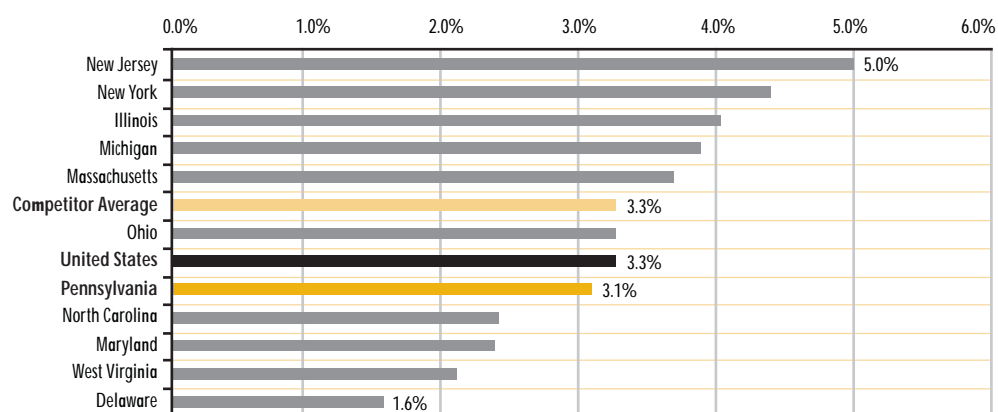


## Local Property Taxes

As noted previously, as a share of state personal income, Pennsylvania's property taxes are lower than the national average. They are also lower than many of our competitor states.

Property taxes in particular areas of Pennsylvania may be higher than in other parts of the state, but on average, property tax levels are much like our other taxes and expenditures, in the middle of the pack.

As a Share of Personal Income, Property Taxes in Pennsylvania Trail National and Competitor State Averages, 2005



Source: The Urban Institute-Brookings Institution Tax Policy Center. State & Local Government Finance Data Query System. Data from U.S. Census Bureau, Annual Survey of State and Local Government Finances, Government Finances, Volume 4, and Census of Governments.

## Education Funding and Property Taxes

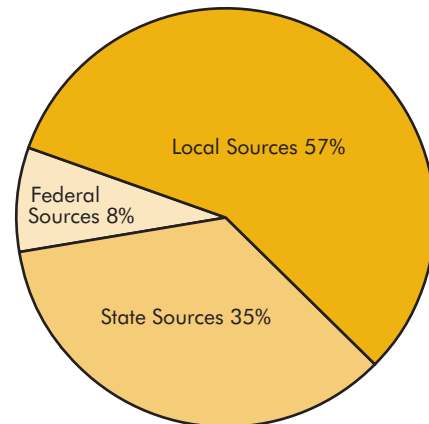
Pennsylvania has been providing free education for its children since 1834. Doing so is a fundamental value of Pennsylvanians. Education debates are not about whether the public should provide education but rather, how best to pay for it.

Local school districts raise most of the funds for public education. In 2005-06, 57% of all school funding was raised locally by school districts. The state currently contributes about a third of the funding, with the federal government making up the rest — less than 10%.

Education debates are not about whether the public should provide education but rather, how best to pay for it.



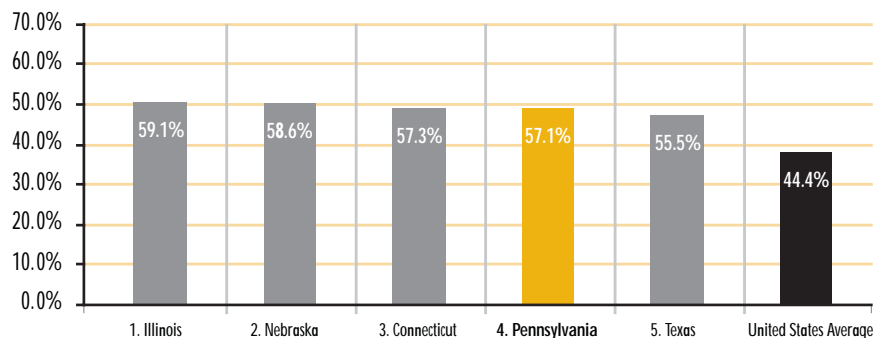
## Local Government Provided More than Half of Elementary-Secondary Education Funding in Pennsylvania, 2005-06



Source: U.S. Census, Public Elementary-Secondary Finances: 2005-06, Table 5.

State tax dollars contribute less to local education funding than 46 other states. Nationally, state governments contribute 47% to the cost of public education while Pennsylvania provides only 35%. Pennsylvania expects local governments to raise 12% more of elementary and secondary school funding than competitor states.

## Pennsylvania Has the Fourth Largest Reliance on Local Funding for Education in the U.S., 2005-06



Source: U.S. Census, Public Elementary-Secondary Finances: 2005-06, Table 5.





## Section VI: Tax Fairness

All tax systems are different, but most Pennsylvanians recognize the need for taxes to finance public investments that benefit everyone. Most people, too, would like the taxes they pay to be “fair.”

When economists talk about fairness or equity, they ask about two different kinds of fairness: do people contribute to the cost of government services based on their ability to pay, and do taxpayers in the same economic circumstances pay similar amounts?

### How Can We Tell if a Tax System is Fair?

When addressing ability to pay, economists have identified three types of tax distributions: regressive, proportional and progressive.

Most people would like the taxes they pay to be “fair.”

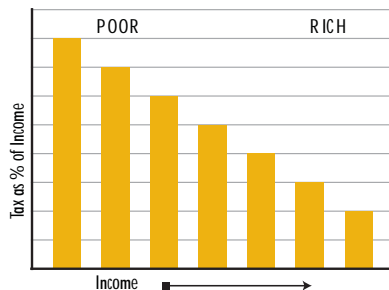


## Types of Taxes

### Regressive Taxes

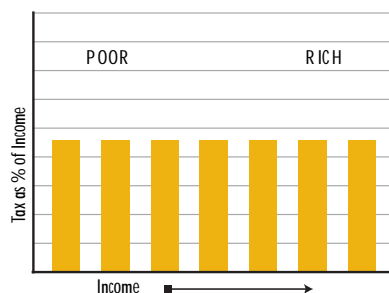
With a regressive tax, poorer individuals pay a larger share of their income than wealthier people.

The sales tax is an example of a regressive tax.



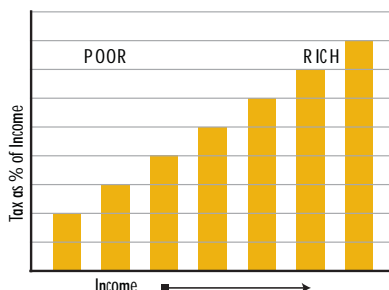
### Proportional Taxes

A proportional or flat tax means that everyone pays the same rate, or the same share of their income in taxes, no matter how much they earn.



### Progressive Taxes

With a progressive tax, people who make more money pay a bigger share of their income than those who make less.



Some people believe that a proportional tax system is fair. If everyone pays the same percentage, they say, the costs and benefits are shared equally. Even a low tax on families in poverty, however, can make it more difficult for them to make ends meet. Although the Pennsylvania Constitution requires that taxes be uniform, it does not require the poor or elderly to pay the same tax rate as other taxpayers. The Constitution allows the legislature to exempt lower-income families from taxes so that these families have more money to pay for basic necessities.

Other observers believe that **progressive taxes are the fairest taxes**. Low-income families can pay a smaller portion of their income, and the tax rates can increase with income, so people pay in taxes a share of their income that they can truly afford. The case for tax rates that rise with income is especially strong in today's economy, when incomes are rising much faster for the most affluent. The federal income tax is an example of a progressive tax, and 36 of 42 states with an income tax use a progressive or graduated tax.

## Tax Fairness: How Do Pennsylvania's Taxes Measure Up?

**Pennsylvania's tax system performs poorly when it comes to tax fairness.** The wealthy pay a small portion of their income in taxes, with a higher burden falling on lower- and middle-income families. As the table on page 43 illustrates, in 2006, the poorest 20% paid more than 12% of their income in sales, property and income taxes, while the top 1% paid less than 5%.

**Our overall tax system is regressive because of our flat income tax.** Pennsylvania's flat income tax fails to offset our regressive sales and property taxes, leaving Pennsylvania with one of the most regressive overall state and local tax systems in the nation.

**Sales taxes are particularly regressive, most affecting poor and middle-income families, but accounting for only a small portion of the income of the wealthiest.** Property taxes also take a bigger bite out of the income of poor and middle-income families.

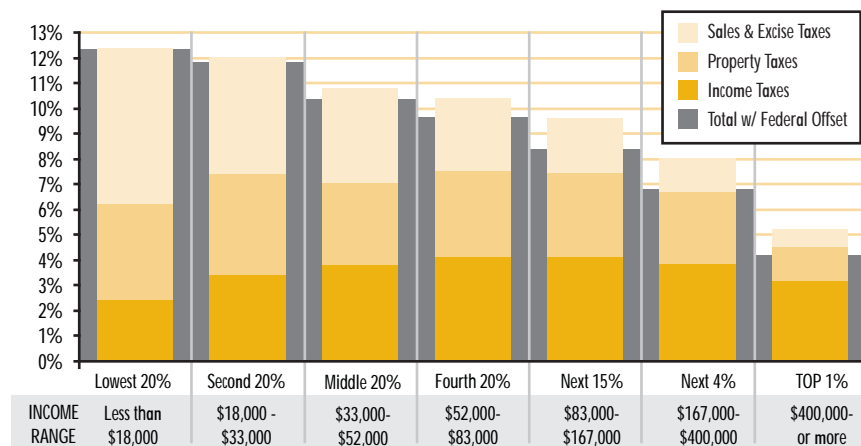
**The federal tax deduction for state and local taxes benefits upper-income taxpayers.** Upper-income families deduct state and local taxes from their income subject to federal tax, reducing their federal income tax. Meanwhile, lower-income taxpayers are much less likely to itemize deductions so that what they pay in

state and local taxes does not reduce their federal income tax. The reduction in federal taxes for upper-income taxpayers but not lower-income taxpayers that results from payment of state and local taxes makes the overall impact of Pennsylvania's state and local income taxes on families even more regressive.

**Tax rates vary by community.** Pennsylvania's highly regressive state and local tax system means that places in the state with a lot of upper-income taxpayers tend to pay the lowest overall tax rate, while poor rural and city areas tend to pay the highest overall tax rate.

Pennsylvania's tax system performs poorly when it comes to tax fairness.

Who Pays? Pennsylvania State and Local Taxes as a Share of Family Income for Non-elderly Taxpayers, 2006



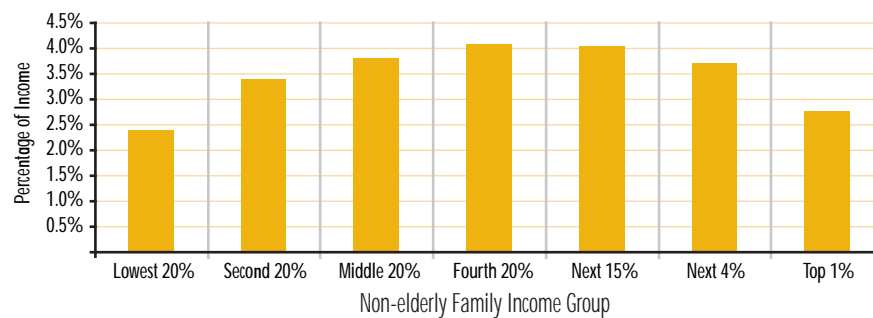
Source: The Institute on Taxation & Economic Policy (ITEP), 2008.

## How Fair is the Personal Income Tax?

**Flat = fair? Maybe not.** As the chart on page 44 shows, middle- and upper-income Pennsylvanians pay about the same share of their income in income taxes. Lower-income Pennsylvanians pay less in state income tax, due to state Tax Forgiveness, but they still must pay local earned income taxes unless they are very poor (usually, less than \$12,000 per year). The top 1% of taxpayers pay 2.8% of their income in taxes after the federal deduction — much less than other taxpayers and much less than their counterparts in competitor states.



## Middle-Income Taxpayers Pay the Highest Share of Their Income in Pennsylvania State and Local Income Taxes



Source: Institute on Taxation and Policy (ITP), 2008.



**BRIGHT IDEA!** Improving the state's Tax Forgiveness program could also increase income tax fairness. To preserve the purchasing power of Tax Forgiveness benefits, eligibility levels could be indexed to inflation or changes in personal income. To ensure that the program helps the truly needy, retirement income could be considered in eligibility income. This could help expand the eligibility income limits without significantly increasing the program's cost. The state could also consider an alternative credit based on the federal Earned Income Tax Credit that could benefit very-low-income families more than the current Tax Forgiveness program.

**Some personal income tax provisions unwittingly benefit wealthy taxpayers. One is the limitless exemption of retirement income.** Most Pennsylvanians would agree that it is not "fair" to tax modest pension incomes. However, the tax currently exempts all such income from tax — meaning you could earn \$100,000 in pension income and not pay any tax. Closely held corporations also receive an unintended bonus from Pennsylvania taxes. The difference in tax they pay from filing as individuals rather than corporations is the largest in the nation.

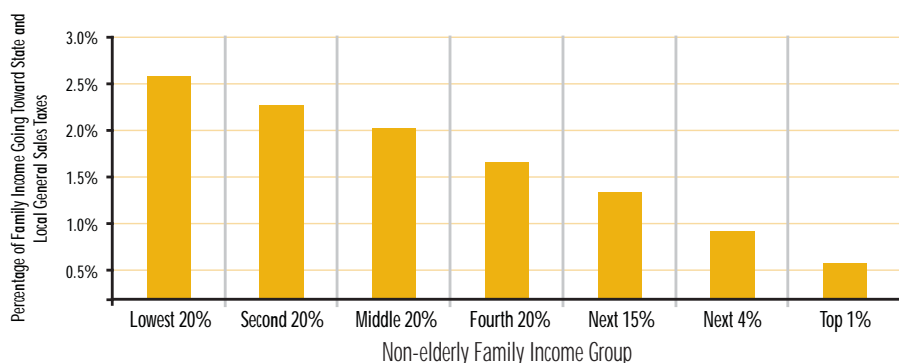
**There are ways to make the PIT fairer.** To align the tax with ability to pay and to reward work, tax rates on unearned classes of income could be increased. Or, exemptions based on the number of taxpayers and dependents in a household could be created and financed by increasing tax rates as income levels rise. However, this option might require a constitutional amendment.

## How Fair is the Sales Tax?

**The sales tax is Pennsylvania's most regressive tax.** Lower-income Pennsylvanians are more likely to live paycheck-to-paycheck, so they save less of their earnings and use a larger share of their income to consume taxable goods and services. They pay a much greater share of their incomes in sales tax than other income groups: 2.5% for the lowest income fifth vs. 1.5% or less for wealthier taxpayers within the top fifth.



## Poorer Pennsylvanians Pay More of Their Incomes in Sales Taxes



Source: Institute on Taxation and Policy (ITEP), 2008.

**Pennsylvania's sales tax has some progressive features.** Pennsylvania exempts groceries and clothing from the sales tax. The tax rate is still lower than many states, especially states that rely heavily on local sales taxes.

Several options could make the sales tax more fair. It could be expanded to cover many of the currently non-taxable services, such as accounting fees, which would distribute the tax a bit more evenly. Other non-essential items currently exempt from sales tax could be added into the base, helping to increase collections. Additionally, the state could offer rebates through the personal income tax code to help offset sales taxes paid by low-income families.



**BAD IDEA!** One proposal that is often considered — raising the sales tax rate to finance property tax cuts — will not aid the equity of the tax. Many lower-income families rent, rather than own, their homes. They also consume more items subject to the sales tax than wealthier families. Raising the sales tax rate to finance property tax cuts pushes the cost of the cuts onto those least able to afford them, and least likely to benefit from them.

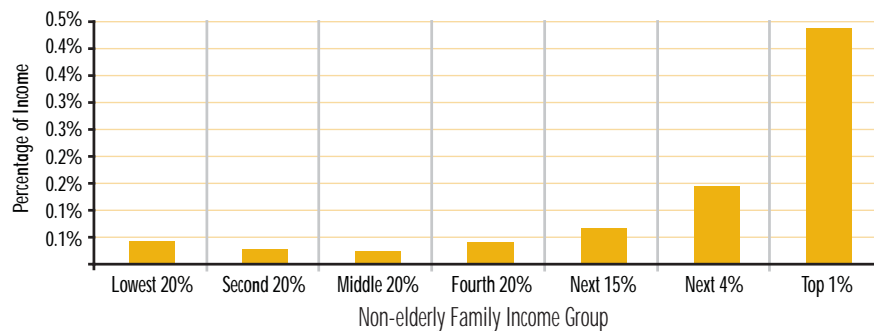
Raising the sales tax rate to finance property tax cuts pushes the cost of the cuts onto those least able to afford them.



## How Fair are Corporate Taxes?

In his study of the 2004 Survey of Consumer Finances, Dr. Edward Wolff found that the wealthiest 10% of Americans held 86% of all individually owned stocks and bonds and 79% of all corporate stock when including pension assets. If taxes on these corporations “flow” to their investors in terms of lower returns, then wealthier Pennsylvanians, particularly the top 1% of taxpayers, indirectly pay the largest share of Pennsylvania corporate taxes.

### Most Corporate Income Taxes are Paid by Wealthy Pennsylvanians



Source: Institute on Taxation and Policy (ITEP), 2008.



**BRIGHT IDEA!** Is it possible to make Pennsylvania’s tax system less regressive? State lawmakers could adopt a constitutional amendment requiring that the overall rate of taxation (from sales, personal income, and other state taxes) be uniform, so that low-, middle-, and high-income families would pay the same share of their income in taxes. They could create a graduated tax so that the wealthiest pay more, and people in lower income cities and rural communities could pay less.



## Section VII:

### Making Revenue Meet the Needs of Today and Tomorrow

By law, Pennsylvania's spending must equal anticipated income every year. This can be a challenge because tax revenue is affected by external forces, like the economy or changes in oil prices.

Sometimes revenue isn't sufficient to maintain current service levels, or costs increase more quickly than revenues.

**A state should strive for revenue adequacy — a stable stream of revenue that grows over time to keep up with the cost of services.** This can be achieved by:

- A good mix of taxes
- A broad tax base with limited exemptions and loopholes
- Sustainable spending

The revenue collected by different taxes grows at varying rates. For example, between 2001 and 2008, Pennsylvania personal income tax revenue grew by

about 3.5% annually without the tax rate increasing. Over the same period, Pennsylvania sales tax revenue increased an average of 2.1% per year.

Revenue from the personal income tax grows because personal income grows steadily over time. Sales taxes grow more slowly because, as living standards rise, people spend less of their money on the goods and services now subject to sales tax. In addition, technological innovation and intense price competition — think Walmart — keep the prices of taxable items steady or even declining.

The corporate net income tax grows quickly during a strong economy, but

Pennsylvania's corporate tax system is notorious for its loopholes, which let certain taxpayers reduce their tax liability by misusing the law.



can fall pretty far when the economy turns sour. Personal income tax revenue also declines during a recession. If consumer spending drops in a bad economy, sales tax collections can decline, even as prices rise.

Some taxes are price sensitive. Gasoline taxes are levied per gallon, so gas price hikes don't translate into higher gas tax collections. But higher gas prices lead to less consumption, so taxes collected drop as fewer gallons are sold.

## Maintaining Revenue Growth to Meet State Needs

Revenue needs will grow due to rising salaries, commodity costs, and health care expenditures, so the state must have a combination of taxes that grows in tandem to meet needs and provide essential services, and limit tax increases.

A variety of legislative actions can reduce taxes collected and undercut revenue adequacy.

**Exemptions:** Lawmakers often favor certain taxpayers or industries by exempting them from sales or other taxes, even when there is no credible evidence that the exemption will create more jobs or higher growth. Exempted items are effectively removed from the tax base.

**Loopholes:** Pennsylvania's corporate tax system is notorious for its loopholes, which let certain taxpayers reduce their tax liability by misusing the law. For example, some Pennsylvania banks involved in mergers avoided paying tax by pointing to ambiguous language in the law and claiming that their out-of-state portions were not, technically, banks. Closing tax loopholes in the corporate income tax through combined reporting would generate \$616 million a year, according to the Department of Revenue.

**Tax credits:** Tax credits are politically popular because they provide a way for legislators to

reduce the taxation of a specific industry or group of taxpayers without having to negotiate for overall changes. However, tax credits reduce the revenue available for other activities.

**Narrow tax bases:** Some things are not taxed. Pennsylvania levies a per-cigarette tax totaling \$1.35 per pack, but it's the only state that doesn't apply the cigarette tax to smokeless tobacco. The sales tax could be broadened to include more luxury goods and services. Also, Pennsylvania is one of only 15 states without a severance tax, which is levied on minerals taken from mines or wells. Other large coal producers like Pennsylvania — Wyoming, West Virginia, and Kentucky — each earn more than \$200 million per year from severance taxes, so Pennsylvania leaves a lot of money on the table.

**Lack of enforcement:** States must enforce tax laws. Otherwise, compliance degrades and tax collections decline. Taxing agencies need resources to verify that individuals and companies are paying the proper taxes.

## Why Does State Spending Grow Over Time?

Over time, in order to meet state needs, state spending typically grows faster than consumer price inflation. To serve the interests of their constituents, state lawmakers need to anticipate and plan for this expansion.

Some people have suggested that state spending should be limited to the rate of inflation plus population growth. But this formula ignores the straightforward reasons why state spending does *and should* grow faster than this.

**The state's economic pie grows faster than inflation plus population, so state government's piece of that pie does, too.** As a result of productivity growth, total state personal income grows





more quickly than inflation plus population growth. Therefore, limiting the growth of state government spending over time to inflation plus population growth would result in *shrinking* state government as a share of the state's overall economy. As we become richer, however, Pennsylvanians tend to demand more of the services state government helps provide, not less — better schools, better roads, better colleges, and better health care.

**The cost of what state government buys grows more quickly than inflation.** The basket of (mostly) services that state government buys is completely different than the goods and services used to measure the consumer price index. Therefore, there is no logical reason that growth of state government spending should bear any relationship to the overall inflation rate.

In fact, the price of most of what state government buys has been growing much faster than general inflation. The cost of health care, a large part of the state budget, has been growing particularly fast. Higher oil prices increase the cost of asphalt needed to repair our roads, and prison costs have grown an average of 4.2% a year for the past 10 years. Welfare reform has brought many new women into the workforce and increased the need for

child care services, and the children of baby boomers have increased demand for college.

**An aging population drives up state spending.** Many Pennsylvanians over 85 years old depend on state-supported nursing home care and home health services, and their number is increasing much faster than the general population.

**The state has an increasingly important role to play in economic growth.** In today's global economy, state investment helps industries and regional economies compete and create good jobs. If Pennsylvania fails to invest smartly in the future, it will be left behind by competitor states and other countries.

**Low spending can be penny-wise and pound foolish.** For example, when we fail to invest in vulnerable children, then 20 years down the road, we pay higher prison costs and have a less productive workforce. (Prison planners actually base their projections of the need for prison beds on the number of failing children in elementary school.) When we arbitrarily limit the growth of state spending, the Commonwealth repairs fewer roads and bridges each year, and tuition at publicly funded institutions of higher education rises more rapidly.

Over time, in order to meet state needs, state spending typically grows faster than consumer price inflation.



## Conclusion: Discussing The Common Good

Current debates about taxes and spending and taxes in Pennsylvania focus very much in the here and now, on the growth of spending this year compared to last or compared to the beginning of the current gubernatorial administration.

Sometimes, it's valuable to lift our heads up out of today's debates and gain a little perspective — to look across time within the United States and across countries.

Are taxes and spending higher now in Pennsylvania and the United States than they were in the 1920s? Absolutely. But ask yourself, are you better off than your grandparents and great-grandparents? We have roads to drive on and affordable public transportation. We have more children attending and graduating from high school and attending college. We have health care for children and pregnant women and for seniors. We allow people with physical and developmental disabilities to live independently and with dignity. We have financial support for people who lose their jobs and education to prepare them for new ones. We have a system that allows every individual, 18 years of age or 80, to take a college course over the Internet. We are living longer than our grandparents ever did.

When we look across the globe we see that countries that maintain a high quality of life tend to be countries with higher tax levels. Does that mean that Pennsylvania's quality of life would improve with higher taxes? Maybe, maybe not. It depends on who pays the taxes and also on what additional spending would buy.

The evidence in this tax primer suggests that it is time for Pennsylvania to move beyond simplistic assertions that taxes are "too high" and "out of control." It is time instead to have more informed discussions about the level and distribution of Pennsylvania taxes and the impact of state and local spending on our quality of life and the public good. This tax primer seeks to lay a foundation for that more fact-based and rational Pennsylvania debate. ■







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